# Employee Benefit Plans

Explanation No. 7

# Top-Heavy Requirements

Worksheet Number 7 (Form 8385) and this explanation are designed to aid the specialist in determining whether a plan is top-heavy as defined in Internal Revenue Code section 416 and, if so, whether the plan meets the special top-heavy requirements of that section.

The sections cited at the end of each paragraph of explanation are to the Internal Revenue Code and the Income Tax Regulations.

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The technical principles in this publication may be changed by future regulations or guidelines.

In general, a plan is top-heavy if the present value of benefits and/or the sum of the account balances for key employees is 60 percent of the sum of account balances and/or benefits for all employees, except former key employees. For years beginning after December 31, 1983, plans to which section 416 of the Code applies are required to contain provisions which will automatically become operative for years in which the plan is top-heavy. A top-heavy plan is required to: (1) provide 3-year 100% or 6-year graded vesting and (2) provide a minimum benefit or contribution to certain non-key employees. Employees may not be excluded from participation in a top-heavy plan because they have not earned a stated amount of compensation, did not make a mandatory contribution, or have withdrawn a mandatory contribution. A top-heavy minimum benefit or contribution may not be integrated with Social Security. In a defined benefit plan, a minimum benefit accrual must be made for each employee who earned a year of service in a top-heavy year, whether the employee has separated from service or not. Section 415 limitations may also have to be adjusted when a plan is top-heavy. If a plan ceases to be top-heavy, it may return to other, less strict, qualification requirements. However, violation of section 411(a)(10) by changes in vesting schedules must be precluded. For top-heavy purposes, a Simplified Employee Pension (SEP) is considered a defined contribution plan.

For plan years beginning before 1989, section 416(d) required a top-heavy plan to limit compensation taken into account for determining benefits to no more than the first $200,000 of compensation in a year. This limit is also applicable to years prior to the year in which a plan becomes top-heavy, but benefits accrued in a year in which the plan was not top-heavy are not reduced when the plan becomes top-heavy. For plan years beginning on or after January 1, 1989, every qualified plan, regardless of whether it is top-heavy, must limit the annual compensation of each employee taken into account under the plan to no more than $200,000 or such higher amount in effect under section 401(a)(17) for the year.

*401(a)(17)*
*416(d), prior to amendment by TRA '86*
*1.416-1 T-40, T-41, T-42*

## I. Applicability of the Top-Heavy Provisions

The worksheet need not be completed beyond this section if the plan is exempt from top-heavy provisions or is not treated as a top-heavy plan. A plan is exempt if:

**Line a.** The plan is not top-heavy and covers only employees who are included in a unit of employees covered by a collective bargaining agreement where retirement benefits were the subject of good faith bargaining in reaching the agreement (this exemption is not available if more than one-half of the employees in the unit are officers, owners, or executives).

**Line b.** The plan is a governmental plan as defined in section 414(d) of the Code.

A plan is not treated as a top-heavy plan for any year that it meets the "SIMPLE" plan requirements of section 401(k)(11) of the Code and permits no contributions other than those required by section 401(k)(11). See Worksheet No. 12.

*416(d)*
*1.416-1 T-36*

Plans of tax-exempt organizations are subject to the top-heavy provisions unless they are covered by one of the exemptions.

*401(a)(10)(B)(ii) & (iii)*
*416(i)(4)*
*1.416-1 T-38*

## II. Provisions Which, if Present, Will Satisfy the Requirements of Section 416

All plans that are not exempt from the top-heavy requirements must include provisions to satisfy the requirements of section 416 for a year in which the plan is top-heavy. However, the provisions described below will satisfy the top-heavy requirements if made effective for all plan years and no participant is or could be a participant in another type of plan maintained by the employer.

**Line a.** Section 416(b) requires more rapid vesting than is required under section 411(a), specifically either: (1) 100% after three years of service, or (2) 20% after two years of service followed by 20% vesting for each subsequent year of service with 100% vesting after six years of service. All accrued benefits must be subject to the minimum vesting schedule, including benefits accrued before the plan became top-heavy. If a plan ceases to be top-heavy, the vesting schedule may be changed to a vesting schedule permitted without regard to section 416 so long as section 411(a)(10) is not violated. Thus, participants with 3 or more years of service must be able to elect the previous top-heavy vesting schedule. The top-heavy vesting schedule applies to all participants, even key employees. However, the accrued benefits of an employee who performs no service after a plan becomes top-heavy are not required to vest under top-heavy rules.

*1.416-1 V-l through V-7*

**Line b.** A defined benefit plan must provide a top-heavy minimum benefit equal to the lesser of 20%, or 2% per year of service, of each non-key employee's average compensation for the five highest consecutive years. For purposes of the defined benefit minimum, the plan may disregard compensation for years (accrual computation periods) ending in plan years which began before January 1, 1984, and compensation for years beginning after the plan has ceased to be top-heavy. Similarly, for purposes of determining years of service for the defined benefit

minimum, the plan may disregard years of service for any plan year beginning before January 1, 1984, and years of service for any plan year in which the plan was not top-heavy. If the accrual computation period does not coincide with the plan year, a minimum benefit must be provided, if required, for both accrual periods within the top-heavy plan year. For a top-heavy plan that does not base accruals on accrual computation periods, minimum benefits must be credited for all periods of service required to be credited for benefit accrual. (See Regs. section 1.410(a)-7.)

The defined benefit minimum is expressed as a life annuity (with no ancillary benefits) commencing at normal retirement age. The minimum benefit may be satisfied with employer-derived benefits accrued, whether or not attributable to years in which the plan is top-heavy.

Each non-key employee who is a plan participant and who has completed at least 1,000 hours of service (or the equivalent) must accrue a minimum benefit in accordance with the top-heavy rules. Also, if non-key employees have been excluded from the plan because compensation is less than a stated dollar amount, they must accrue a minimum benefit.

Each non-key employee otherwise eligible for a benefit accrual must receive a minimum defined benefit without regard to employment on a specific date, compensation of less than a stated amount, or failure to make a mandatory contribution. The plan may not permit forfeiture of the minimum accruals on account of the withdrawal of a mandatory contribution. Also, a non-key employee may not be precluded from receiving a minimum benefit because the participant is a former key employee.

*1.416-1 M-1 through M-6, M-13*

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**Line c.** The minimum contribution (including forfeitures allocated) required in a top-heavy defined contribution plan is at least 3% of compensation (within the meaning of section 415) for that plan year. A lower minimum contribution is permissible if no key employee is allocated an amount in excess of 3% of compensation and non-key employees are allocated a percentage equal to the highest percentage of compensation allocated to any key employee. Amounts contributed pursuant to a salary reduction agreement must be included in determining the amount contributed on behalf of a key employee when the minimum contribution will be less than 3% (except for plan years beginning before January 1, 1985). However, for plan years beginning after December 31, 1988, the plan may not treat such contributions as employer contributions for the purpose of satisfying the minimum contribution or benefit requirements.

Each non-key employee (including a non-key employee who is a former key employee) otherwise eligible for a contribution must receive a minimum contribution, if there has been no separation from service, without regard to whether the employee has completed a year of service, earned compensation of less than a stated amount, or made a mandatory contribution. The plan must also preclude forfeiture of account balances on account of the withdrawal of a mandatory contribution.

*1.416-1 M-7, M-10, M-11*
*1.416-1 M-20*

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**Line d.** Compensation used for determining a minimum benefit-minimum contribution is the compensation described in section 1.415-2(d) of the regulations. Alternatively, compensation that would be stated on an employee's Form W-2 for the calendar year that ends with or within the plan year may be used. The same definition of compensation must generally be used for all top-heavy purposes. For purposes of determining whether an employee is a key employee (with respect to plan years beginning on or after January 1, 1989), the compensation that is taken into account is compensation as defined in section 415(c)(3), but specifically including amounts contributed by the employer pursuant to a salary reduction agreement, even though these amounts may be excludible.

*416(i)(1)(D)*
*1.416-1 T-21, M-2, M-7*

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**Lines e. & f.** A plan must require that the provisions described in questions a, b, and c or d be operative for any year the plan is top-heavy. A plan may also make these provisions operative for each year of the plan after the effective date of section 416. If the plan makes such provisions operative for all years the plan will meet the requirements of section 416 unless a participant is or may become covered under both a defined benefit and a defined contribution plan of the employer.

*Tax Reform Act of 1984, section 524(c)*
*1.416-1 T-36*

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## III. Test for Top-Heaviness

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**Line a.**

(1) A determination date is the last day of the preceding plan year, or in the case of the first plan year, the last day of such year. Key employee and top-heavy tests are made as of the determination date.

*416(g)(4)(C)*
*1.416-1 T-22, T-23*

(2) A valuation date is the annual date on which plan assets must be valued for the purpose of determining the value of account balances or the date on which liabilities and assets of a defined benefit plan are valued. For the purpose of top-heavy tests, the valuation date for a defined benefit plan must be the same valuation date used for computing plan costs for minimum funding. The valuation date for a defined contribution plan must be the most recent valuation date within a 12-month period ending on the determination date.

*1.416-1, T-24, T-25*

(3) Each plan of an employer in which a key employee participates, (in the plan year containing the determination date or any of the four preceding plan years) and each other plan which enables any plan in which a key employee participates during the period tested to meet the requirements of section 401(a)(4) or 410(b), are required to be aggregated for top-heavy testing purposes and are considered the required aggregation group. All employers

aggregated under section 414(b), (c), or (m) are considered a single employer. If a required aggregation group is top-heavy, each plan in the group is top-heavy. If the required aggregation group is not top-heavy, no plan in that group is top-heavy. In the case of a multiple employer plan, each employer must meet the requirements of section 416 with respect to that employer's employees. If one employer participating in a multiple employer plan is top-heavy, the plan must provide the top-heavy minimums, vesting, etc., for all employees of the employer covered by the plan. If the plan does not so provide, all employers will be considered to be maintaining a plan which is not a qualified plan. Where non-key employees do not participate in more than one plan, each plan must separately provide the applicable minimum contribution or benefit with respect to each such participant.

*416(g)(2)(A)(i)*

*1.416-1 G-2, T-2, T-6, T-9, T-10*

(4) A permissive aggregation group is one or more plans that are required to be aggregated plus one or more plans that are not required to be aggregated but which may be aggregated with a required aggregation group. A plan may be permissively aggregated only if the resulting aggregation group satisfies the requirements of section 401(a)(4) and 410. If the resulting permissive aggregation group is not top-heavy, no plan in the group is top-heavy. If the permissive aggregation group is top-heavy, only plans in the required aggregation group are top-heavy.

*416(g)(2)(A)(ii)*

*1.416-1 T-7, T-8, T-11*

(5) A defined benefit plan is top-heavy when the ratio of the present value of accrued benefits for key employees to the present value of accrued benefits for all employees exceeds 60%. A defined contribution plan is top-heavy when the ratio of account balances for key employees to account balances for all employees exceeds 60%. If there is more than one plan, the top-heavy ratios must be consolidated by adding together the numerators and then adding together the denominators to form one ratio. All distributions made during the five-year period ending on the most recent determination date must be taken into account. Nondeductible employee contributions are to be included. For plan years beginning after December 31, 1984, any accrued benefit or account balance of an individual who has not performed services for the employer during the five-year period ending on the determination date shall not be taken into account. However, former key employees are non-key employees and are excluded entirely from both the numerator and denominator of any fraction used to determine top-heaviness.

*416(g)(1)*

*1.416-1 T-1, T-23 through T-32, T-39*

(6) A key employee is any employee or former employee (including a deceased employee) who at any time during the plan year containing the determination date, or the four preceding plan years, is or was: (1) an officer of the employer having compensation in excess of 50 percent of the dollar limit in effect under section 415(b)(1)(A) for the calendar year in which such plan year ends; (2) one of the ten employees having compensation from the employer greater than the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends and owning (or considered as owning within the meaning of section 318) both more than a ½ percent interest as well as one of the ten largest interests owned in the employer; (3) a 5-percent owner of the employer; or (4) a one-percent owner of the employer having compensation in excess of $150,000.

Compensation considered in determining who is a key employee (with respect to plan years beginning on or after January 1, 1989), is compensation as defined in section 415(c)(3), but specifically including amounts contributed by the employer pursuant to a salary reduction agreement, even though these amounts may be excludible.

An individual may be considered a key employee in a plan year for more than one reason. However, in testing whether a plan or group is top-heavy, an individual's accrued benefit is counted only once. The accrued benefits of a deceased employee retain the character of key or non-key employee status as if the employee were living.

For purposes of determining who is a key employee, the aggregation rules provided in section 416 and in section 414 are not applied when determining ownership. Percentage of ownership is determined in the following manner: first, the value of all outstanding stock in the employer must be determined; then, the value of stock owned by an individual participant is converted to a percentage of the total value of outstanding stock. For the 1-percent and 5-percent tests, the percentage of total voting power owned by a potential key employee must also be determined. For noncorporate entities, ownership of capital or profits is substituted for ownership of stock and the attribution rules of section 318 are applied analogously.

*416(i)*

*1.416-1 T-12 through T-21*

(7) A non-key employee is any employee who is not a key employee. Non-key employees include employees who are former key employees.

*416(i)(2)*

*1.416-1 T-1, T-12*

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**Line b.** For a single plan, the top-heavy tests are made as of the determination date. The present value of accrued benefits or the valuation of account balances must be determined as of the most recent valuation date which is within a 12-month period ending on the determination date. In a defined contribution plan, the account balance as of the valuation date must be adjusted for contributions due as of the determination date. In the case of a defined contribution plan not subject to the minimum funding requirements of section 412, the adjustment is generally the amount of any contributions actually made after the valuation date but on or before the determination date. However, in the first year of such a plan, the adjustment should also include the amount of any contributions made after the determination date that are allocated as of a date in that first plan year. In the case of a defined contribution plan that is subject to the minimum funding standards, the account balance should include contributions that would be allocated as of a date not later than the determination date, even though those amounts are not yet required to be contributed. In the case

of a defined benefit plan, the present value of accrued benefits is computed as if the employee had separated from service on: (i) either the valuation or the determination date of the first plan year; or (ii) the valuation date for all other plan years. For the second plan year of a plan, the accrued benefit taken into account for a current participant must not be less than the accrued benefit taken into account for the first plan year unless the difference is attributable to using an estimate of the accrued benefit as of the determination date for the first plan year and using the actual accrued benefit as of the determination date for the second plan year. Where more than one plan is involved, a separate determination is first made for each plan on its determination date. The plans are then aggregated by adding the results of each separate determination for such dates that occur within the same calendar year. The combined results will indicate whether or not the plans so aggregated are top-heavy.
*416(g)*
*1.416-1 T-22 through T-25*

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**Line c.** A defined benefit plan must specify reasonable actuarial assumptions for determining the present value of accrued benefits for purposes of the top-heavy test. Interest and post-retirement mortality assumptions must be made. Pre-retirement mortality and future increases in cost-of-living (but not increases in section 415 limitations) may be assumed. However, assumptions as to future withdrawals or future salary increases may not be used. Benefits not relating to retirement benefits must not be taken into account. The assumptions used for determining present values need not be the same as those used for minimum funding purposes or for determining the actuarial equivalence of optional benefits under the plan but must be definitely determinable (see Rev. Rul. 79-90). The assumptions used do not have to be related to the plan's actual experience. If the plan specifies assumptions that reflect reasonable mortality experience (on acceptable mortality tables) and an interest rate of not less than 5 percent nor greater than 6 percent, such assumptions are deemed reasonable.
*1.416-1 T-26*

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**Line d.** If an aggregation group Includes two or more defined benefit plans, the same actuarial assumptions must be used with respect to all such plans and must be specified in such plans.
*1.416-1 T-19*

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**Line e.** A subsidized benefit is a benefit payable in a form other than the normal retirement benefit which is greater than the actuarial equivalent of the normal retirement benefit. A subsidy is nonproportional unless it applies to a group of employees that would independently satisfy the requirements of section 410(b). Proportional subsidies are not taken into account when determining the present value of accrued benefits.
*1.416-1 T-26, T-27*

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**Line f.** Only nonproportional subsidies are taken into account when determining the present value of accrued benefits. Thus, a defined benefit plan must provide that nonproportional subsidies are taken into account.
*1.416-1 T-26, T-27*

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**Line g.** In determining whether a plan (or plans) is top-heavy, a participant's accrued benefit in a defined benefit plan must be determined using the method uniformly used for accrual purposes for all plans of the employer. If there is not such a uniform method, then the accrued benefit is to be determined as if it accrued not more rapidly than the slowest rate of accrual permitted under the fractional rule.
*416(g)(4)(F)*

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## IV. Employer Maintaining Multiple Plans - Coordination of Top-Heavy Minimums

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If an employer maintains more than one plan, non-key employees covered under only a defined benefit plan must receive the defined benefit minimum. Non-key employees covered only by a defined contribution plan must receive the defined contribution minimum. The minimum benefit is described in Section II.c. of this Explanation. The minimum contribution is described in section II.d.

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**Line a.** Where all plans involved are defined contribution plans, only one plan need provide the minimum contribution for all participants of a required aggregation group. However, each other plan in the aggregation group is required to implement the top-heavy vesting rules.

Where employees are covered under both defined benefit and defined contribution plans, appropriate minimums may be provided in each plan. Also, required duplication or inappropriate omission, may be avoided by using one of the approaches described in b. through d. below. Where more than one plan is maintained for the same employees and employees receive the minimum under only one plan, the plans must contain provisions to assure any employees who subsequently fail to receive appropriate minimums under that plan, because, for example, it is terminated, will still receive minimums under one of the plans.
*416(f)*
*1.416-1 M-8, M-12*

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**Line b.** The plans may provide the minimums in the defined benefit plan or provide a floor offset whereby the defined benefit minimum is provided in the defined benefit plan and offset by the vested employer derived benefits provided under the defined contribution plan.
*1.416-1 M-12*
*Rev. Rul. 76-259*

**Line c.** Another safe harbor that may be used in the case of employees covered under both defined benefit and defined contribution plans is to prove, using a comparability analysis, that the defined contribution plans are providing benefits for each non-key employee at least equal to the defined benefit minimum.
*1.416-1 M-12*

**Line d.** In order to avoid the cost of providing the defined benefit minimum alone, the complexity of a floor offset plan, or the fluctuation of a comparability analysis, a safe haven minimum defined contribution may be provided. If contributions and forfeitures under the defined contribution plan equal 5 percent of compensation for each year the plan is top-heavy, such minimum will be presumed to satisfy the section 416 minimums. The plan document must specify the method that will be used to satisfy the required minimums.
*1.416-l M-12, M-13, M-15*

## V. Super Top-Heavy

A super top-heavy plan is a top-heavy plan under which the present value of accrued benefits and/or account balances for all key employees exceeds 90% of the present value of accrued benefits and/or account balances for all employees. Again, former key employees (who are non-key employees) are excluded entirely from the calculation. In general, section 416(h) modifies the aggregate defined benefit and defined contribution rules of section 415(e) to provide that, in computing the defined benefit and defined contribution fractions for a top-heavy plan, a factor of 1.0 is applied to the dollar limit instead of 1.25. If a defined benefit plan has no participants who are or could also be participants in a defined contribution plan (or vice versa), the plan need not include provisions describing the defined benefit or defined contribution fractions or provisions for determining whether the plan is super top-heavy.
*416(h)(1)*
*1.416-1 T-33*

**Lines a. & b.** There are exceptions to the general rule which are described below. However, when the top-heavy ratio exceeds 90%, the 1.0 factor must always be applied.
*416(h)(2)(B)*
*1.416-1 T-33*

**Line c.** A top-heavy plan with a ratio which does not exceed 90% may use a section 415 factor of 1.25 if the defined benefit minimum is increased by one percentage point for each year of service up to a maximum of 10 percentage points and the defined contribution minimum is increased to 4 percent of compensation for participants covered only by a defined contribution plan.

Participants covered by both a defined benefit and defined contribution plan must receive the defined benefit minimum. The same approaches as discussed in section IV. apply, except that the 5 percent defined contribution safe harbor is increased to 7½ percent. The plan document must specify the method to be used.
*1.416-1 T-33, M-14, M-15*